No. 10037

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

PACIFIC SOUTHWEST REALTY COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY BRIEF.

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TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

CASES.

STATUTES.

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Respondent's Distinction of Prior Decisions of This Court Is Not Sound.

In petitioner's opening brief it was pointed out that by the specific terms and conditions of petitioner's securities designated Cumulative Preferred Serial Stock petitioner had a definite and legally enforceable obligation to repay to the holders of said securities on or before a specified date the principal sum of said securities and the fixed annual return regardless of earnings or profits of petitioner. The rights of the holders of said securities were limited to the return of the sums advanced plus the fixed annual return. This Court and other courts have consistently and repeatedly held that where a corporation has a definite obligation of that type to holders of its

securities the obligation is indebtedness and the payments made thereon are interest regardless of the fact that the securities might be named stock and the payments thereon might be named dividends.

Commissioner v. Palmer, Stacy-Merrill, Inc. (CCA 9, 1940), 111 F. (2d) 809;

Commissioner v. Proctor Shop, Inc. (CCA—9, 1936), 82 F. (2d) 792;

Commissioner v. O. P. P. Holding Co. (CCA—2, 1935), 76 F. (2d) 11;

Helvering v. Richmond F. & P. R. Co. (CCA—4, 1937), 90 F. (2d) 971;

Bolinger-Franklin Lumber Co. v. Commissioner, 7 B. T. A. 402;

Diamond Calk Horse Shoe Co. v. United States, (D. C. Minn., July 19, 1940. Opinion reported 1940 Prentice-Hall Federal Tax Service, para. 62919, and 1940 C. C. H. Federal Tax Service, para. 9641) (Appeal dismissed—C. C. A. 8, 116 F. (2d) 284);

Commissioner v. J. N. Bray Co. (CCA—5, Mar. 13, 1942), ... F. (2d) .....

The basis of the above decisions is that the true nature of a security, like any other contract, is to be determined from its terms and conditions and not from the names used and that a definite obligation to repay the principal sum with a fixed annual percentage return thereon which must be paid on or before a definite date is consistent only with a debt and not with a stock, preferred or otherwise.

In some cases the courts have received and considered evidence *aliunde* the contract which established that such an obligation existed between the corporation and the holders of its securities, even though the terms of the security itself did not so provide.

Arthur R. Jones Syndicate v. Commissioner, 23 F. (2d) 833;

Commissioner v. Proctor Shop, Inc. (CCA—9, 1936), 82 F. (2d) 792;

Commissioner v. Palmer, Stacy-Merrill, Inc. (CCA —9, 1940), 111 F. (2d) 809.

Respondent does not question the soundness of the cases cited nor show wherein the basic facts in the case at bar differ from the basic facts in the cited cases. Respondent refers only to *Commissioner v. Proctor Shop, Inc., supra,* and *Commissioner v. Palmer, Stacy-Merrill, Inc., supra.* Respondent asserts that those two cases are distinguishable from the case at bar because there was evidence, outside the contract, that the parties intended to create a debt or, in other words, intended that the corporation should have a definite obligation to repay the principal sum and designated return on or before a specified date, even though the contract between the parties did not expressly so provide. In the case at bar such obligation was expressly imposed upon petitioner by the contract itself. Additional evidence was not necessary to establish that petitioner was so obligated to the holders of its securities and that the obligation was enforceable against the general assets of petitioner.

It does not follow, from the fact that in the mentioned cases evidence *aliunde* the contract was received and con-

sidered in determining the true character of the contract, that such evidence is necessary in cases in which the obligation established by such evidence is expressly provided in the contract between the parties. Neither does it follow that the principle of those cases is inapplicable where the necessary obligation appears from the express terms of the contract without the aid of additional evidence.

In *Diamond Calk Horse Shoe Co. v. United States* (D. C. Minn. Reported in 1940 Prentice-Hall Federal Tax Service, para. 62919, and 1940 C. C. H. Federal Tax Service, para. 9641; Appeal dismissed—C. C. A. 8, 116 F. (2d) 284, the facts were almost identical with the facts in the case at bar. There the court stated:

> "There is no need to seek facts *aliunde* the so-called stock certificate. The legal effect of the contract between the corporation and the holder of the certificate requires a finding that a debtor-creditor relationship exists, and dividends paid thereunder are, and were, interest payments within the meaning of the statute."

Petitioner makes no contention that there was any understanding or agreement between it and the holders of its securities which was not fully expressed in the contract between them. On the contrary, petitioner bases its contentions entirely upon the terms and conditions expressly included in the certificates which evidenced the securities and in petitioner's Certificate of Incorporation.

Petitioner submits that the distinction which respondent attempts to draw between the case at bar and *Commissioner v. Proctor Shop, Inc., supra,* and *Commissioner v. Palmer, Stacy-Merrill, Inc., supra,* is not sound. Petitioner further submits that said decisions are squarely in point and support petitioner's contentions.

Deputy v. du Pont Is Not in Point.

Respondent cites *Deputy v. du Pont,* 308 U. S. 488, to the effect that every obligation is not indebtedness. In the cited case it was held that an obligation to return borrowed stock was not indebtedness and that sums paid as a carrying charge for the use of the stock were not interest on indebtedness. The facts and the decision in that case have no bearing upon the facts and issues in the case at bar. Petitioner does not suggest a departure from the usual definition of interest, namely "the amount which one has contracted to pay for the use of borrowed money". Petitioner's contention is that the so-called dividends paid to the holders of its securities designated Cumulative Preferred Serial Stock were payments which it contracted to pay for the use of money borrowed from the security holders for a definite and limited time and that said payments were in fact interest despite the name given to them.

The Statutory Definition of Dividend Is Not Applicable.

Respondent states that the payments to the holders of petitioner's securities come within the definition of dividends as contained in Section 115(a) of the Revenue Act of 1936. The statutory definition of dividends includes only distributions to stockholders. If, as petitioner contends, the terms and conditions of the securities establish that the holders thereof were creditors and not stockholders, Section 115(a) clearly has no application.

Incidental Facts Did Not Change Petitioner's Obligation to Its Security Holders.

Respondent points to several incidental facts such as the inclusion of the securities in the Certificate of Incorporation as part of the authorized capital, the statement in the prospectus that in the opinion of counsel "dividends" would not be subject to normal income tax, and the failure of petitioner to take deductions for the payments in its income tax returns prior to 1937.

None of the mentioned facts in any way changed the terms and conditions of the securities or relieved petitioner from its obligation to repay the principal and so-called dividends on or before the maturity dates specified. It cannot be doubted that all parties understood that the investment was for a definite period, for a fixed rate of return and that the principal and so-called dividends were to be paid on or before maturity from the general assets of petitioner, if necessary. Those facts were stressed in all the negotiations and documents, including those in which the opinion of counsel with regard to the taxability of the so-called dividends was stated.

The securities considered in *Commissioner v. Proctor Shop, Inc., supra,* were also listed as part of the capital stock of the corporation, but that fact was not considered important by the court. The fact that counsel were of the opinion that the so-called dividends were not subject to normal tax is of no greater importance than the fact that the securities were named stock and the payments were named dividends and the opinion was undoubtedly influenced by the names used. The courts have held without exception, that the true character of a security is to

be determined from its terms and not by the names used by the parties.

The payments were treated as dividends on the tax return for the reason that the persons who prepared the returns accepted the names given to the payments as indicating their true character without inquiring into the terms of the securities. [R. 132.]

The So-Called Dividends Were Not Limited to Earnings and Profits.

Respondent's statements that the so-called dividends were to be paid from surplus or net profits is not entirely correct. The current payments were to be made out of the surplus or profits but upon maturity or prior liquidation any accumulated payments were enforceable against the general assets of petitioner, the same as any unconditional claim or debt. [R. 185, 188.] Petitioner's liability to pay the so-called dividends at the annual rate specified was in no way limited by its surplus or profits. A similar provision was contained in the securities considered in *Commissioner v. O. P. P. Holding Co.* (CCA—2, 1935), 76 F. (2d) 11.

The Cases Relied on by Respondent Are Distinguishable.

Respondent cites and quotes extensively from the opinion of this Court in *In re Culbertson's*, 54 F. (2d) 753 and *Armstrong v. Union Trust & Savings Bank*, 248 F. (2d) 268. The cited cases were bankruptcy and receivership proceedings in which holders of securities designated preferred stock sought to share with the general creditors in

the distribution of the assets. All the court was required to decide was whether the holders of the particular securities were entitled to share with general creditors. Courts have always been loathe to allow holders of securities called stock to share equally with general creditors in insolvency proceedings, particularly where the holders of such securities have been held out as stockholders with the right to share in profits and excess assets on dissolution. Furthermore, the right to share with general creditors is not essential to indebtedness for even where the rights of holders of a particular security were expressly made subordinate to the rights of general creditors this and other courts have held that the securities were nevertheless debts.

> *Commissioner v. Proctor Shop, Inc.* (CCA—9, 1936), 82 F. (2d) 792;
>
> *Commissioner v. O. P. P. Holding Co.* (CCA—2, 1935), 76 F. (2d) 11.

Also, the terms of the securities considered in the cited cases differed in material respects from the terms of petitioner's securities. In *In re Culbertson's, supra,* the court construed the agreement to require the payment of dividends only from profits. Petitioner's agreement specifically required the payment of the so-called dividends from general assets, if necessary, upon the maturity dates or upon prior liquidation. [R. 185, 188.]

In *Armstrong v. Union Trust & Savings Bank, supra,* in the portion of the opinion omitted from respondent's quotation, the court stated:

> "These certificate purchasers must be held to full knowledge and appreciation of the real character of their investments, and that they were to become

participants in the enterprise, and not mere creditors of the corporation. To intimate otherwise would be to impugn their intelligence. *No doubt they expected to share in whatever dividends were declared on the stock after payment of the stipulated interest, and to await the declaration of such dividends until the earnings of the capital stock would warrant such action. They could not well expect such dividends and at the same time claim that their certificates constituted them creditors.* Creditors are entitled to no dividends on their demands. What they might get from the company would go in the way of a discharge of the liability, either partially or entirely. The two positions are wholly inconsistent. They must be considered either stockholders or creditors. They cannot be both." (Italics supplied.)

Unlike the security holders in the *Armstrong* case, the holders of petitioner's securities had no right whatsoever to participate in any profits of petitioner for it was specifically provided that they should receive no more than the specified annual percentage. [R. 157, 192.]

It is submitted that *Armstrong v. Union Trust & Savings Bank, supra,* and *In re Culbertson's, supra,* are distinguishable both on the facts and the issues from the case at bar. It is of interest to note that neither of said cases was apparently considered sufficiently in point to be cited by this Court in the two cases subsequently decided by this Court on the exact issue here involved.

Commissioner v. Proctor Shop, Inc. (CCA—9, 1936), 82 F. (2d) 792;

Commissioner v. Palmer, Stacy-Merrill, Inc. (CCA —9, 1940), 111 F. (2d) 809.

In the case at bar there was more than a mere agreement to redeem. Petitioner's securities stated a definite maturity date for each security. Upon arrival of the maturity date petitioner had a definite obligation to repay the principal sum and any unpaid so-called dividends regardless of profits. This obligation was not dependent upon any election by petitioner or the holders of the securities but was imposed by the terms of the security itself and was enforceable against the general assets of petitioner, the same as any unconditional claim or debt. The right of the holders of said securities to receive annual payments ceased upon the maturity date and the holders had no further rights, except to receive repayment of the principal and so-called dividends accumulated prior to the maturity date. The above provisions were all expressly stated in the contract between petitioner and the security holders. Such conditions are consistent only with indebtedness and are not consistent with a stockholder's interest in a corporation.

Such conditions were not contained in the securities considered in any of the cases cited by respondent.

Furthermore, in *Kentucky River Coal Corporation v. Lucas,* 51 F. (2d) 586, the decision of the court seems to be based upon the conclusion that the rights of the holders of the securities in question were subordinate to the rights of general creditors. In *Commissioner v. Proctor Shop, Inc.,* 82 F. (2d) 792, this Court held the security to be indebtedness, even though the rights of the holder thereof were specifically made subordinate to the rights of general creditors. The Circuit Court of Appeals for the Second Circuit rendered a similar decision in *Commissioner v. O. P. P. Holding Co.,* 76 F. (2d) 11. It also appears, as re-

spondent states, that in *Kentucky River Coal Corp. v. Lucas, supra,* the dividends were limited to surplus profits and earnings.

In *Finance & Investment Corporation v. Burnet* (C. A. D. C. 1932), 57 F. (2d) 444, and *Jewel Tea Co. v. Burnet* (CCA—2, 1937), 90 F. (2d) 451, no date was fixed for the maturity of the securities. It is well settled that one of the essential elements of a debt is a definite maturity date fixed in advance. (*Commissioner v. Schmoll Fils Association, Inc.* (CCA—2, 1940), 110 F. (2d) 611; *Elko Lamoille Power Co. v. Commissioner* (CCA—9, 1931), 50 F. (2d) 595.)

In *Koeppler v. Crocker Chair Co.,* 200 Wis. 476, 228 N. W. 130, the holders of the securities had the right to participate in the assets on liquidation.

Petitioner submits that the authorities cited by respondent are not inconsistent with petitioner's contentions and do not support respondent's contentions herein. It is further submitted that the decision of the Board of Tax Appeals herein was erroneous and contrary to the decisions of this Court in *Commissioner v. Proctor Shop, Inc., supra,* and *Commissioner v. Palmer, Stacy-Merrill, Inc., supra,* and should be reversed.

Respectfully submitted,

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May, 1942.